85-1220

Supreme Court, U.S.
FILED
JAN 21 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. _____

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1985

HUGH KNOELL BUILDERS, INC.,

Petitioner,

v.

FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION, an Arizona corporation,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE STATE OF ARIZONA

JOHN P. OTTO
45 West Jefferson, 5th Floor
Phoenix, Arizona 85003
(602) 252-7461
Attorney for Petitioner

QUESTION

CAN THE ARIZONA APPELLATE COURTS, ON AN AD HOC BASIS, VIOLATE BOTH ARIZONA CONSTITUTIONAL AND STATUTORY OBLIGATIONS TO RENDER WRITTEN OPINIONS WHICH STATE THE GROUNDS THEREFORE, WITHOUT VIOLATING THE DUE PROCESS AND EQUAL PROTECTION CLAUSES OF THE FOURTEENTH AMENDMENT TO THE CONSTITUTION OF THE UNITED STATES.

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FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION,
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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE STATE OF ARIZONA

To The Honorable Supreme Court of the United States:

Comes now Hugh Knoell Builders, Inc., as Petitioner, pursuant to Supreme Court Rule 21 and submits the following in support of his Petition for Writ of Certiorari to review a decision and judgment of the Court of Appeals for the State of Arizona. The denial of a Petition for Review by the Supreme Court of Arizona.

REFERENCE TO OFFICIAL REPORTS

The official reference to the decision of the Court of Appeals is: An unpublished Memorandum Decision contained herein as Appendix "1".

GROUNDS OF JURISDICTION

The jurisdiction basis upon which a petition is found are:

1. The Memorandum Decision of the Court of Appeals of the State of Arizona, dated the 23rd day of April, 1985 (Appendix "1").

2. The denial by the Arizona Supreme Court of a timely Petition for Review dated the 22nd day of October, 1985 contained herein as Appendix "2".

3. The jurisdiction of this Court is invoked under 28 USC §1257.

CONSTITUTIONAL PROVISIONS, STATUTES, AND RULES OF PROCEDURE INVOLVED

Provisions of law applicable to the case are:

a. The 14th Amendment to the Constitution of the United States — Appendix "3".

b. Article 6, Section 2 of the Constitution of the State of Arizona — Appendix "4".

c. Article 6, Section 9 of the Constitution of the State of Arizona — Appendix "5".

d. A.R.S. §12-120.07 — Appendix "6".

STATEMENT OF THE CASE

The Superior Court (trial court) of the State of Arizona directed a verdict against the Petitioner below, Hugh Knoell Builders, Inc.[1] on its claim for fraud against First Federal Savings and Loan Association on the basis that Knoell had failed to prove any damages.

The facts supporting Knoell's damages are set forth in the Petition for Review set forth herein in Appendix "7".

The Court of Appeals of the State of Arizona rendered its decision on the appeal affirming the trial court's ruling with-

[1] The parties hereto, pursuant to Supreme Court Rule 21(1)(b) are: Hugh Knoell Builders, Inc., an Arizona corporation and First Federal Savings and Loan Association, a Federal Savings and Loan Association.

out discussion, without stating the grounds for its decision and without stating the reasons for the affirmance of the ruling of the trial court. The totality of the decision by the Court of Appeals is as folows:

> "This appeal has been considered by the Court, Presiding Judge Meyerson, and Judges Grant and Haire participating.
>
> Appellant contends that the trial court erred in denying its motion for a new trial and entering judgment in favor of appellee upon a directed verdict. The basis of the trial court's ruling was that appellant failed to establish any damages resulting from appellee's alleged fraudulent conduct. We have carefully reviewed the offer of proof made by appellant at the conclusion of its case. We agree with the trial court that appellant failed to demonstrate any damages resulting from any action on the part of appellee.
>
> Appellee may submit a claim for attorney's fees in accordance with Rule 12(c), Arizona Rules of Civil Appellate Procedure.
>
> Affirmed." (Appendix "1" hereto)

The Arizona Supreme Court refused to require the Court of Appeals to comply with its duty to state the reasons for its decision denying review without opinion. (Appendix "2" hereto) No further review in the Arizona court's is available.

The Petitioner contends that the failure of the Court of Appeals to state in writing the grounds for its decision or to detail the reasons for its decision, and the Arizona Supreme Court's failure to require it to do so denies Petitioner both due process of law and the equal protection of the law required by the Fourteenth Amendment to the Constitution of the United States.

REASON FOR GRANTING THE WRIT

The Constitution of the State of Arizona, Article 6, Section 2 provides in pertinent part:

> "The Supreme Court shall sit in accordance with rules adopted by it, either in banc or in divisions of not less than three justices, but the Court shall not declare any law unconstitutional except when sitting in banc. The decisions of the court shall be in writing and the grounds stated."

The totality of the decision of the Court of Appeals is set forth supra, and in Appendix "1" hereto.

The substance of the Court's opinion in essence merely states that they have examined the ruling of the trial court and find it to be correct. "Affirmed". Such cavalier treatment of the critical issue of damages involved in this case is hardly commensurate with the constitutional and statutory duty imposed upon the appellate courts of this state to state their decision in writing and to state the grounds for that decision.

The constitutional provisions with reference to the Court of Appeals are contained in Article 6, Section 9 of the Constitution of the State of Arizona which provides:

> "The jurisdiction, powers, duties and composition of any intermediate appellate court shall be as provided by law."

A.R.S. §12-120.07 provides in pertinent part:

> "The opinions of a division or of a department of the Court of Appeals shall be in writing, the *grounds stated*, and shall be concurred in by a majority of a department if heard by department or of the division if heard by the division."

Thus, both the constitutional and statutory criteria for opinions of the appellate courts of Arizona are the same.

Black's Law Dictionary defines an "opinion" as:

> "The statement by a judge or court of the decision reached in regard to a cause tried or argued before them, *expounding the law as applied to the case, and*

> *detailing the reasons upon which the judgment is based.*" Black's Law Dictionary, Revised 4th Ed.

The unpublished "Memorandum Decision" as it was characterized by the Court of Appeals meets neither the statutory nor the constitutional criteria required of appellate courts in Arizona. The definition of an "opinion" contained in Black's Law Dictionary gives life to the long extant commonlaw definition of "opinion".

Additionally, any effective review of the decision of the Court of Appeals by the Arizona Supreme Court is greatly diminished by virtue of the Court of Appeals having failed to discuss the issues involved in the appeal, the complete lack of authority cited for its conclusion and the non-existence of any reasons for the conclusion reached by the Court of Appeals.

Even the Arizona Supreme Court recognized this when it said in *Phelps Dodge Corporation v. Industrial Commission*, 90 Ariz. 379, 368 P.2d 450 (1962):

> "Essentially, petitioner's dissatisfaction is reflective of a problem not without some vexatious aspects. The constitution requires that the court's decision be in writing and the grounds stated. Article 6, Section 2. Certainly, parties to litigation are entitled to be advised of the reasons persuading the court to its conclusion."

This Court continued its discussion of the issue raised by *Phelps Dodge* and which is raised by Petitioner here in the following analysis:

> "Petitioner's assertion that the disposition 'was without fully considering the arguments advanced' gives us concern. If Petitioner means that the decision did not refute each argument advanced in Petitioner's brief, Petitioner is correct, it did not. Nor was it so intended. But if it is meant that the Court failed to negotiate with Petitioner the subtle course of its reasoning, then there is some justification in the request for reconsideration. We do not discourage applications for rehearing. It is the last opportunity to correct error. But here, it is

plain that Petitioner was fully understood the first time around."

In the case at bench, it is impossible to determine whether Petitioner's claims asserted in the Court of Appeals were fully understood or not. The cursory "Memorandum Decision" gives no hint as to what the issues even were, let alone whether the Court fully understood them. There are no reasons stated other than that the Court of Appeals agrees with the trial court. There is no statement as to what the trial court held or why it did so. It merely says that a verdict was directed against the Plaintiff in favor of the Defendant and that decision is "affirmed". It certainly cannot be said that the Petitioner has been "advised of the reasons persuading the court to its conclusion".

Petitioner recognizes that there is no constitutional right to appeal from the decision of a state trial court. The rule that *is* federally constitutionally mandated, however, is succinctly set forth in *Lindsey v. Normet*, 405 U.S. 56, 92 S.Ct. 862, 31 L.Ed.2d 36 (1972). There the Court said:

> "This court has held that if a full and fair trial on the merits is provided, the Due Process Clause of the Fourteenth Amendment does not require a state to provide appellate review, ... and the continuing validity of these cases is not at issue here. When an appeal is afforded, however, it cannot be granted to some litigants and capriciously or arbitrarily denied to others without violating the Equal Protection Clause. (citations omitted) (405 U.S. at 77)."

The constitutional and statutory grant of appellate rights by Arizona to all litigants has created a class of which the Petitioner is a member. That is, those persons entitled to appeal in the state court system of Arizona. As previously pointed out, both constitutionally and statutorily, the appellate courts are required to grant to all appellants the right to have the opinion "in writing" and "the grounds stated".

When an appellate court does not state the grounds of its opinion, those members of the class situated, as is Petitioner here, have been arbitrarily denied, on an ad hoc basis, the rights of other members of the same class in cases in which the court does state the grounds.

Thus, when the Court of Appeals refused to state its reasons for the conclusion which it reached and merely affirmed the trial court without any true opinion, the Court created the "unreasoned distinction which the Fourteenth Amendment forbids the state to make" condemned in *Williams v. Oklahoma City*, 395 U.S. 458, 89 S.Ct. 1818, 23 L.Ed.2d 440 (1969).

As this Court pointed out in *Rinaldi v. Yeager*, 384 U.S. 305, 86 S.Ct. 1497, 16 L.Ed.2d 577 (1966) the Equal Protection Clause requires more than a merely non-discriminatory application within the class. It also imposes a requirement of some rationality in the nature of that class. Once the right to appellate review is given, those avenues of review must be kept free of unreasoned distinctions that can only impede open and equal access to the courts. *Rinaldi*, supra at 311 of 384 U.S. and the cases cited therein.

To write an opinion which is totally bereft of any exposition of the law as applied to the case and totally failing to detail the reasons upon which the judgment is based is to write no opinion at all.

Even the Arizona Supreme Court recognized in *Phelps Dodge Corporation v. Industrial Commission*, supra that parties to litigation are entitled to be advised of the reasons which persuade the court to its conclusion as a matter of constitutional prerogatives in Arizona. Thus, the Court of Appeals' failure to do so in this case constitutes a denial of both due process and equal protection under the provisions of the Federal Constitution.

There is yet another and important reason why this type of arbitrary, cursory disposition of a case by the Court of Appeals fails to meet constitutional muster. It is axiomatic

that if one is given a right to appeal that right is necessarily a right to a meaningful appeal.

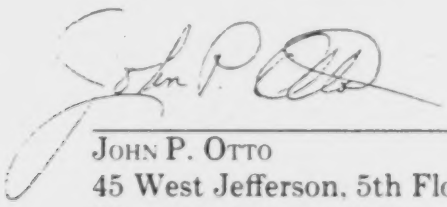
By failing to write an opinion detailing its reasons and applying the law applicable thereto, the Court of Appeals has effectively denied Knoell the right to a meaningful appeal to the Arizona Supreme Court when review of its decision is sought in that forum.

It is immediately apparent that no meaningful review of the Court of Appeals' decision can be had in the Arizona Supreme Court when the Court of Appeals has given neither the Petitioner nor the Supreme Court anything to review as to its reasoning.

The basic issue in this case is quite simple. Can the courts of Arizona abandon Knoell's right to have his appeal decided by a written opinion, as that term is known to the law, without running squarely into the mandate of the Fourteenth Amendment requiring both equal protection and due process. It is respectfully submitted that it cannot.

It is respectfully submitted that the Petition for Certiorari should be granted and the Arizona Court of Appeals be required to state the grounds for its conclusion in this case.

Respectfully submitted,



JOHN P. OTTO
45 West Jefferson, 5th Floor
Phoenix, Arizona 85003
(602) 252-7461

APPENDICES

Appendix 1: Memorandum Decision

Appendix 2: Supreme Court Opinion

Appendix 3: 14th Amendment to the Constitution of the United States

Appendix 4: Article 6, Section 2 of the Constitution of the State of Arizona

Appendix 5: Article 6, Section 9 of the Constitution of the State of Arizona

Appendix 6: §12-120.07. Opinions; Publication

Appendix 7: Appeal from the Superior Court of Maricopa County, Cause No. C-361349, with Appendices 1-9

Appendix 1

IN THE COURT OF APPEALS
STATE OF ARIZONA
DIVISION ONE

HUGH KNOELL BUILDERS, INC., Plaintiff-Appellant, v. FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION, an Arizona corporation, Defendant-Appellee.	1 CA-CIV 7068 DEPARTMENT D MEMORANDUM DECISION (Not for Publication-Rule 28, Arizona Rules of Civil Appellate Procedure)

Appeal from the Superior Court of Maricopa County
Cause No. C-361349
The Honorable Joseph D. Howe, Judge
AFFIRMED

Marvin Johnson, P.C.
by John P. Otto
Attorneys for Plaintiff-Appellant — Phoenix

Jennings, Strouss & Salmon
by Charles R. Hoover
Michael A. Beale
Jefferson L. Lankford
Attorneys for Defendant-Appellee — Phoenix

This appeal has been considered by the Court, Presiding Judge Meyerson, and Judges Grant and Haire participating.

Appellant contends that the trial court erred in denying its motion for a new trial and entering judgment in favor of

appellee upon a directed verdict. The basis of the trial court's ruling was that appellant failed to establish any damages resulting from appellee's alleged fraudulent conduct. We have carefully reviewed the offer of proof made by appellant at the conclusion of its case. We agree with the trial court that appellant failed to demonstrate any damages resulting from any action on the part of appellee.

Appellee may submit a claim for attorney's fees in accordance with Rule 21(c), Arizona Rules of Civil Appellate Procedure.

Affirmed.

Appendix 2

Supreme Court

DAVID R. COLE
CLERK

STATE OF ARIZONA

DIANA K. BENTLEY
CHIEF DEPUTY CLERK

201 WEST WING STATE CAPITOL
1700 WEST WASHINGTON
PHOENIX, ARIZONA 85007-2866

October 23, 1985

RE: HUGH KNOELL BUILDERS, INC. vs.
FIRST FEDERAL SAVINGS AND LOAN
Supreme Court No. 18260-PR
Court of Appeals No. 1 CA-CIV 7068
Maricopa County No. C-361349

GREETINGS:

The following action was taken by the Supreme Court of the State of Arizona on October 22, 1985, in regard to the above-referenced cause:

"ORDERED: Petition for Review = DENIED."

"Justice Cameron did not participate in the determination of this matter."

Record returned to the Court of Appeals, Division One, Phoenix, this 23rd day of October, 1985.

DAVID R. COLE, Clerk

To: John P. Otto, Esq., Marvin Johnson, P.C.
Jefferson Lankford, Esq., and Michael Beale, Esq., Jennings, Strouss & Salmon
Glen D. Clark, Clerk, Court of Appeals, Division One

Appendix 3

14th Amendment to the Constitution of the United States

All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

Appendix 4

Article 6, Section 2 of the Constitution of the State of Arizona

§2. Supreme court; composition; divisions; decisions, transaction of business

Section 2. The Supreme Court shall consist of not less than five justices. The number of justices may be increased or decreased by law, but the court shall at all times be constituted of at least five justices.

The Supreme Court shall sit in accordance with rules adopted by it, either in banc or in divisions of not less than three justices, but the court shall not declare any law unconstitutional except when sitting in banc. The decisions of the court shall be in writing and the grounds stated.

Appendix 5

Article 6, Section 9 of the Constitution of the State of Arizona

Section 9. The jurisdiction, powers, duties and composition of any intermediate appellate court shall be as provided by law.

Appendix 6

§12-120.07. Opinions; publication

A. The chief judge shall assign three of the judges to each department, and such assignment may be changed by him from time to time. Each of the departments shall have the power to hear and determine causes and all questions arising therein. The presence of three judges shall be necessary to transact any business in either of the departments; except such as may be done in chambers and except as may be otherwise permitted by law. The opinions of a division or of a department of the court of appeals shall be in writing, the grounds stated, and shall be concurred in by a majority of a department if heard by a department or of the division if heard by the division. An opinion of a division or a department of a division shall be the opinion of the court of appeals.

B. The opinions of the court of appeals shall be published and distributed in the same manner as provided for the publication and distribution of opinions of the supreme court.

Appendix 7

MARVIN JOHNSON, P.C.
45 West Jefferson, 5th Floor
Phoenix, Arizona 85003
Telephone: (602) 252-7461
Attorneys for Appellant

THE SUPREME COURT
STATE OF ARIZONA

HUGH KNOELL BUILDERS, INC., Appellant, vs. FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION, an Arizona corporation, Appellee.	1 CA-CIV 7068 Appeal from the Superior Court of Maricopa County, Cause No. C-361349 PETITION FOR REVIEW

The Appellant, Hugh Knoell Builders, Inc. (hereinafter "Knoell") petitions this Court for review pursuant to Rule 23 of the Rules of Civil Appellate Procedure and asks this Court to reverse the decision of the Court of Appeals, Division One and to reverse the decision of the trial court in this cause.

Respectfully submitted this 25th day of June, 1985.

MARVIN JOHNSON, P.C.

By /s/ JOHN P. OTTO
John P. Otto
Attorneys for Appellant

I. SYNOPSIS OF THE DECISION OF THE COURT OF APPEALS

"This appeal has been considered by the Court, Presiding Judge Meyerson, and Judges Grant and Haire participating.

Appellant contends that the trial court erred in denying its motion for a new trial and entering judgment in favor of appellee upon a directed verdict. The basis of the trial court's ruling was that appellant failed to establish any damages resulting from appellee's alleged fraudulent conduct. We have carefully reviewed the offer of proof made by appellant at the conclusion of its case. We agree with the trial court that appellant failed to demonstrate any damages resulting from any action on the part of appellee.

Appellee may submit a claim for attorney's fees in accordance with Rule 21(c), Arizona Rules of Civil Appellate Procedure.

Affirmed." (Appendix "1" hereto)

This cursory "opinion" is the most succinct synopsis that could be written. (See discussion infra)

II. ISSUES PRESENTED FOR REVIEW

1. When the evidence and the reasonable inferences derived therefrom shows Knoell to have suffered actual damages of approximately $300,000 plus other damages, was it error for the trial court to direct a verdict against Knoell on the basis that Knoell had suffered no damages?

2. That by virtue of the Court of Appeals having failed to carry out the statutorily and constitutionally mandated duty Petitioner has been denied any effective review by this Court of the decision of the Court of Appeals.

III. THE FACTS MATERIAL TO THE CONSIDERATION OF THE ISSUE PRESENTED

At the close of Knoell's case, the trial court felt that there was sufficient evidence before the jury to take the case to the jury on the issue of fraud insofar as the first eight elements

thereof were concerned. (TR, Vol. V, pgs. 47-48, Appendix "8" hereto)

The sole basis for the trial court's directing a verdict in favor of First Federal was that the court felt that there was no evidence of damage to Knoell. The Court said at the close of the evidence:

> "Based on the evidence presented to the jury and the evidence in the offer of proof, I believe there is not evidence of damage and, therefore, I'll grant the motion." (TR, Vol. V, pg. 91, Appendix "8" hereto)

During the period 1974, '75 and '76, First Federal Savings and Loan Association was in a fast growth period and was failing to meet certain net worth requirements required by the Federal Home Loan Bank Board (FHLBB) and its regulations and more particularly described by the Examination Reports of the FHLBB contained in Exhibit "1" which contained copies of portions of First Federal's examination reports from the FHLBB, the federal regulatory agency which supervises federal savings and loan associations. First Federal also was violating many other requirements of the FHLBB and was being heavily criticized by the examiners. (See the testimony of Henry Quon, TR, Vol. IV, pgs. 114-133 & 148-168, Appendix "7" hereto)

The examination reports showed that First Federal had gotten into deep difficulty with the examiners because it attracted a great deal of new deposit money on which it had to pay a high interest rate. Then it invested that money in speculative loans to builders in order to return a high enough yield to the association to not only be able to pay the high interest rate to its depositors, but to show a profit as well.

Hugh Knoell advised First Federal his corporation could not continue. (TR, Vol. III, pg. 182, Appendix "6" hereto) First Federal promised Knoell that if he would continue they would see him through if it took five years. (TR of Nov. 24, 1982, pgs. 4-5, Appendix "4" hereto) Knoell, based on First Federal's assurances, incurred additional indebtedness to

First Federal for additional interest costs and borrowed an additional $60,000 to release the liens by materialmen against the property. (TR of Nov. 24, 1982, pg. 15, Appendix "4" hereto) It was to First Federal's advantage to have Knoell do all these things because of the difficulty First Federal was then in with the federal regulatory authorities, (FHLBB). (TR, Vol. V, pgs. 148-160, Appendix "8" hereto)

To induce Knoell to continue in business and borrow more money, the false representation was made to Knoell that First Federal would continue to finance his operation. Though the Phoenix real estate market had deteriorated considerably, First Federal was attempting to withhold from the examiners and the Federal Home Loan Bank Board that a number of its interim construction loans and projects were in serious trouble. (TR, Vol. IV, pgs. 150-168, Appendix "7" hereto) The report further demonstrated that as soon as First Federal had worked its way out of the severe criticism leveled at it in the examination reports that it thereupon reneged on all of its promises to Knoell, foreclosed on all of the Knoell projects and thereby retrieved for its own account all of the company's assets as well as depriving Knoell of its equity in the properties owned by Knoell and then in the process of development. (TR of Nov. 30, 1982, pgs. 41-43, Appendix "5" hereto)

The report further indicated that the Federal Home Loan Bank Board felt that there were so many violations of the federal regulations governing savings and loan associations that it seemed that management had lost control over the situation and as a result, the federal regulatory authorities were considerably concerned. (TR, Vol. IV, pgs. 167-168, Appendix "7" hereto)

Based upon all of the evidence, the trial court felt that eight of the nine elements of fraud had been sufficiently established in a prima facie case to take the case to the jury.

The case came down to the question of whether or not Knoell had demonstrated, in the evidence, damages of even $1.00 so that the case could be submitted to the jury. The

trial court felt that there was no evidence of *any damage* and therefore granted the motion to First Federal for a directed verdict. (TR of Nov. 30, 1982, pg. 44, Appendix "5" hereto)

The evidence of damage to Knoell may be fairly summarized as follows:

1. Hugh Knoell testified that First Federal had deprived Knoell of $300,000 in equity on the Quail Hill project. (TR of Nov. 30, 1982, pg. 43, Appendix "5" hereto and Vol. V, pg. 90, Appendix "8" hereto)

2. On page 94 of Appendix "3", the Examination Report, the Quail Hill development by Knoell was appraised by First Federal as shown by First Federal's books that the Quail Hill property was valued by First Federal at $4,122,537. The amount of debt which First Federal had as first lien against the property and which Knoell got credit for was shown in Exhibit "9" at Footnote 9 (Appendix "9" hereto) was $3,329,635 when First Federal foreclosed on the property and acquired it from Knoell. If one merely takes the difference between the value of the property as appraised by First Federal of $4,122,537 and applies against this the amount credited to Knoell of $3,329,635, the difference or the *equity* of Knoell which was acquired by First Federal amounts to $792,902 based on First Federal's own appraisal.

Further, First Federal's records, as compiled and summarized by the Federal Home Loan Bank Board Examination Report, on page 101 of Exhibit "1" (Appendix "2" hereto) the association's appraisal is shown as $4,107,740 and that First Federal then had a total investment of $3,342,826 in the property. Taking the association's appraisal at face value and First Federal's then investment therein of $3,342,826, First Federal acquired the equity of Knoell in the property in the amount of $764,914.

First Federal was unwilling for Knoell to take bankruptcy and urged Hugh Knoell to borrow more money. (TR of Nov. 24, 1982, pg. 3, Appendix "4" hereto) This resulted in the Knoell loan on the surface being current on First Federal's books, which was solely to First Federal's advantage. (TR,

Vol. IV, pgs. 159-160 & 164-166, Appendix "7" hereto) First Federal promised to Knoell that they would see him completely through the crisis even if it took five years. (See the testimony of Hugh Knoell, TR of Nov. 24, 1982, pgs. 4-5, Appendix "4" hereto) The evidence further showed that having failed to accomplish their purpose of fooling the regulatory authorities, First Federal then broke all of its promises to Knoell and took the property in a coerced deed in lieu of foreclosure (TR of Nov. 30, 1982, pgs. 41-42, Appendix "5" hereto) and thus reversed to itself the equity that otherwise would have gone to Knoell upon the ultimate sale of the properties at the time when the real estate market became firm again. (See Appendix "2" hereto, pg. 101 of the Examination Report) Additionally, the net book value (investment) of First Federal, after it had acquired the property was shown to be $3,491,749 (Appendix "2" hereto) and shows First Federal set the actual market value of the property at $3,784,056. This constitutes a net equity of $292,307 which Knoell was prevented by First Federal's fraud from realizing. This figure coincides with Mr. Knoell's testimony that First Federal acquired Knoell's equity of $300,000. (TR of Nov. 30, 1982, pg. 43, Appendix "5" hereto)

3. Knoell suffered additional damages by borrowing more money and incurring additional interest charges and incurred additional debt to discharge the materialman's liens based on the false representations of First Federal.

IV. REASONS WHY THE PETITION SHOULD BE GRANTED

A. The argument of First Federal in moving for a directed verdict was based upon the fact that testimony and exhibits (particularly Exhibit "9", a financial statement prepared by Knoell's accountant) showed the Quail Hill *land* was being carried on Knoell's books at its book value, (i.e., its acquisition cost), coupled with the fact that First Federal gave Knoell credit for $3,329,635 when First Federal foreclosed that this resulted in a profit to Knoell of $543,593. First Federal's argument thus took the position that because a paper

profit was made by Knoell between its *acquisition* cost of the land and the amount of credit given Knoell by First Federal when it obtained a deed in lieu of foreclosure (under duress) that this resulted in Knoell suffering no damages.

Mr. Knoell testified that the company's *"equity"* in the spring of 1975 was probably $300,000. (TR of Nov. 30, 1982, pg. 43, Appendix "5" hereto)

Thus, the question upon which the trial court's decision turned is nakedly presented:

> "Is the equity value which a company has in a piece of property equatable with whether or not it made a paper 'profit' upon the forced sale of that land?"

The simple answer to the question is to be found in Mr. Knoell's testimony, the testimony of Mr. William Farrow, a CPA who had long acted as the accountant for Knoell and in Exhibit "9", Footnote 9 which was heavily relied upon by First Federal in urging its Motion for a Directed Verdict. (See Appendix "9" hereto)

The necessary starting point for a determination of the amount of equity which Knoell had in Quail Hill property is to define what *"equity"* is both legally and factually.

Black's Law Dictionary, Revised 4th Edition defines "equity" as follows:

> "The remaining interest belonging to one who has pledged or mortgaged his property, or *the surplus of value which may remain after the property has been disposed of for the satisfaction of liens.* The amount or value of property *above the total liens or charges. Des Moines Joint Stock Land Bank of Des Moines v. Allen,* 220 Iowa 448, 261 N.W. 912"

Thus, by definition "equity", in a piece of property is the value of the property *above* the total liens which are against the property. Footnote 9 in Exhibit "9" discloses:

> "In May, 1975, the company conveyed the undeveloped land and lots it owned at its Quail Hill project to the

mortgagee, First Federal Savings and Loan Association, in exchange for the complete *release of all indebtedness on the land and lots.* The cost of the land and the lots was $2,786,042 and the liabilities released totaled $3,329,635."

Counsel for First Federal and the trial court, at First Federal's urging, took the position that since the *cost* of the land was less than the amount of indebtedness released, that this resulted in a paper profit on the books of Knoell of $543,593 and therefore, since Knoell had made a paper profit by virtue of the release of the liens against the land totaling $3,329,635 that Knoell had suffered no damage by virtue of the deprivation of its *"EQUITY"* by First Federal's involuntary taking of the land.

First Federal, the trial court and apparently, the Court of Appeals confused the term "equity" with "profit". There is no necessary correlation between "equity" and "profit" when discussing the market value of the land. Mr. Farrow, the CPA made it quite clear in his testimony that the amount of money carried on Knoell's books as to the value of the Quail Hill property represented only the *cost* of the land to Knoell. (TR, Vol. III, pg. 169, Appendix "6" hereto) The acquisition cost of the land to Knoell has absolutely no relationship to the fair market value of that land when it is later sold after being improved. The equity which Knoell had in the property represented the amount of money that the property could be sold for *after* the repayment of all of the liens which were held by First Federal against the property.

Mr. Knoell testified as follows:

"Mr. Otto: Do you have an opinion as to what your equity in the land was worth when it was taken from you from First Federal? The answer to that is either you do or you don't.

Mr. Knoell: Well, I do to the extent that there was an equity in there that Hugh Knoell Builders had. To relate it to the spring of '75, probably $300,000.

Mr. Otto: In equity?

Mr. Knoell: In equity." (TR, Vol. V, pg. 90, Appendix "8" hereto)

Thus, it becomes immediately apparent that the equity Mr. Knoell testified to which was taken away from Knoell by First Federal in the spring of 1975 was $300,000, i.e., by definition this was the amount of money that Knoell Builders would have realized from the sale of the land after all of First Federal's liens had been discharged. (Black's Law Dictionary, supra)

First Federal in the trial court relied upon Exhibit "9" and Footnote 9 thereof to demonstrate that the amount that First Federal gave credit to Knoell Builders for when it repossessed the land was the sum of $3,329,635. However, Mr. Knoell's testimony is undisputed that in addition to the amount of $3,329,635 that Knoell got credit for in discharging the liens held by First Federal, there was an additional $300,000 in profit which would have been realized by Knoell had First Federal lived up to its commitments and not involuntarily taken the land from Knoell. Thus, as a result of its fraud, First Federal deprived Knoell of that $300,000 in equity.

To compare the amount First Federal gave Knoell credit for when it acquired the land and released the mortgages it held on the property, in the sum of $3,329,635 with the original cost of the land to Knoell is to compare apples and oranges.

The fair market value of the land is certainly not represented by its acquisition cost to Knoell. The fair market value of the land is what it could be sold for by a willing seller to a willing purchaser. *American Surety Co. of N.Y. v. Nash*, 95 Ariz. 271 at 277; 389 P.2d 266 and *Mastick v. State*, 118 Ariz. 366 at 370, 576 P.2d 1366.

The confusion which arose in the trial court's mind, induced by the argument of First Federal, was the confusion between profit and equity. We would suggest to the Court that the following analogy is directly applicable to this case:

"If 'A' buys a $5.00 fountain pen in 1900. 'A' then keeps the pen for a period of 63 years, the market value of such a pen has obviously increased from the original $5.00 cost. Assume, arguendo, that it is now worth $100.00 as an antique pen.

'A' then, in need of money, mortgages the pen to First Federal receiving therefore the sum of $50.00. First Federal now has a lien on the pen of $50.00. If First Federal then wrongfully forecloses its mortgage on the pen and give credit to 'A' for $50.00, does that mean that the wrongful foreclosure has resulted in no damage to 'A'? Does this mean that 'A' has not been deprived of his additional $50.00 of equity in the pen merely because his cost was only $5.00? First Federal's argument then is: 'Well, he received $50.00 in credit for the pen, he therefore made a paper profit of $45.00 (even though the pen was worth $100.00) and 'A' therefore has suffered no damage.' "

First Federal's position is that if they gave credit to Knoell, in wrongfully obtaining Knoell's property, for even one dollar more than Knoell paid for the property that Knoell has suffered no damage by being wrongfully deprived of its property because Knoell made a profit even though the fair market value of that property was $300,000 more than it got credit for. Mr. Knoell's testimony that there was approximately $300,000 in equity in the Quail Hill property at the time it was wrongfully taken must be taken as true, together with all reasonable inferences that may be drawn therefrom, when challenged by a Motion for a Directed Verdict. *Brand v. J.H. Rose Trucking Co.*, 102 Ariz. 201, 427 P.2d 519.

Applying the definition of Black's Law Dictionary and the definition in the practical world of what constitutes equity, it becomes immediately and unequivocally clear that the evidence was undisputed that First Federal had deprived Knoell of its $300,000 in equity over and above the amount of First Federal's liens.

In addition to this evidence, which is certainly more than sufficient to withstand a directed verdict, the Federal Home Loan Bank Board Reports in evidence demonstrate that the fair market value of the land together with the improvements as appraised by First itself was $4,107,740. On page 101 of Exhibit "1" (the Federal Home Loan Bank Board examination reports) contained in Appendix "2" hereto, its shows that the Quail Hill property was appraised by First Federal in the sum of $4,107,740. Page 94 of Exhibit "1" (Appended hereto as Appendix "3") shows that Quail Hill was carried on First Federal's books as of November of 1976 at $4,122,537 and that First Federal then had the property on the market for an asking price of $3,784,056.

It is immediately apparent that both of these figures are considerably above the price First Federal gave Knoell credit for of $3,329,635. This certainly creates an inference that the fair market value of the land acquired from Knoell by First Federal was at least $3,784,056. A subtraction of these figures yields that by First Federal's own records it represented to the Federal Home Loan Bank Board that the fair market value of the property was at least $454,421 more in 1976 than it had been when it acquired the land from Mr. Knoell together with his equity therein in 1975. It is also a fair inference from First Federal's own figures that Mr. Knoell's estimate of approximately a $300,000 equity in '75 was worth $454,421 in equity to First Federal in 1976.

There is yet further evidence of other damage to Knoell. Knoell took on additional indebtedness based on First Federal's fraud.

Rather than place the company in bankruptcy as he had contemplated and as he had been advised to do by both his lawyer and accountant in December of 1974, Knoell, based upon the assurances of continuing financial support by First Federal, incurred an additional $48,724 in interest costs from December 1974 until September 11, 1975. (TR, Vol. V, pgs. 21-22, Appendix "8" hereto)

In addition to the damages incurred by virtue of Knoell's loss of equity, the corporation incurred additional liabilities by virtue of the new loan foisted on Knoell by First Federal of $684,000, which resulted in Knoell's paying an additional $48,724 in interest it would otherwise not have been obligated for. (TR, Vol. V, pgs. 22-24, Appendix "8" hereto)

In *Cole v. Gerhart*, 5 Ariz. App. 24, 423 P.2d 100, the Court quoted with approval Professor Proser's statement in his Law of Torts, §105, page 752 (3d ed. 1964):

> "In addition to such normal measure of damages under whatever rule the Court may adopt, the plaintiff may recover for *consequential damages*, such as personal injuries, damage to other property, or *expenses* to which he had been put, provided that they are regarded as 'proximate' results of the misrepresentation." (Emphasis supplied)

This Court in *Cole* adopted the rule which would necessarily include the interest paid to First Federal which except for the fraud would never have been incurred and the additional borrowing by Knoell in order to pay off the subcontractor's liens for the benefit of First Federal. (TR of Nov. 24, 1982, pg. 15, Appendix "4" hereto) In doing so, the Court in *Cole* approved the rationale of what it described as a leading case in the area of *Selman v. Shirley*, 161 Ore. 582, 85 P.2d 384 (1938); Supplemental Opinion 161 Ore. 582, 91 P.2d 312, 124 ALR 1, 16 (1939) that:

> "We are likely to become so engrossed in efforts to formulate a rule of damages capable of precise application in all future cases and incapable of misapplication in any, that we may lose sight of our real duty in the present case; which is to *sift out the charges of fraud, and, if it then appears that the alleged wrongdoer is guilty of the charges made against him, to enter judgment against him for all damages which are the proximate result of the wrong which he committed . . .*
>
> Regardless of whether the out-of-pocket loss rule or the benefit-of-the-bargain rule is the correct one, the fundamental rule, universally employed, is the one just in-

dicated: *the victims of fraud are entitled to compensation for every wrong which was the natural and proximate result of the fraud.*" (Emphasis ours)

Thus, in addition to Knoell's loss of equity, it incurred additional indebtedness to both First Federal of $684,000 on which it paid additional interest and became indebted for an additional $60,000 in indebtedness to Hugh Knoell which was necessary in order to pay off the liens for the benefit of First Federal. Under the rationale of the rule enunciated in *Cole*, there are additional damages proximately resulting from the fraud of First Federal which the trial court failed to recognize.

It is respectfully submitted that based upon Mr. Knoell's testimony that Knoell was damaged in the sum of $300,000 by First Federal's having wrongfully deprived Knoell of its equity created a justiciable jury issue on the question of damages and was more than sufficient to withstand a directed verdict based solely on the fact that Knoell had suffered no damages.

When this is coupled with the exhibits in evidence showing First Federal's appraisal of the fair market value of the property and its having offered the property for sale for a sum which was $454,421 in excess of the amount it gave credit to Knoell for, creates an inference which standing along must permit the case to go to the jury.

Additionally, Knoell has been damaged by the incurring of additional debt and interest charges.

It is therefore respectfully submitted that the judgment of the Superior Court should be reversed and the case remanded for submission to the jury.

B. The "DECISION" of the Court of Appeals Denies Petitioner Meaningful Review and is Violative of the Constitution and Statutes of the State of Arizona.

The Constitution of the State of Arizona, Article 6, Section 2 provides in pertinent part:

> "The Supreme Court shall sit in accordance with rules adopted by it, either in banc or in divisions of not less than three justices, but the Court shall not declare any law unconstitutional except when sitting in banc. The decisions of the court shall be in writing and the grounds stated."

The totality of the decision of the Court of Appeals is set forth supra in Appendix "1" hereto.

It is important to note that neither the Appellant or the Appellee in the Court of Appeals agreed that the case could be disposed of under Procedure "B" which does not require an opinion.

The substance of the Court's opinion in essence merely states that they have examined the ruling of the trial court and find it to be correct. "Affirmed". Such cavalier treatment of the critical issue involved in this case is hardly commensurate with the constitutional duty imposed upon the appellate courts of this state to state their decision in writing and to state the grounds for that decision.

The constitutionl provisions with reference to the Court of Appeals are contained in Article 6, Section 9 of the Constitution of the State of Arizona which provides:

> "The jurisdiction, powers, duties and composition of any intermediate appellate court shall be as provided by law."

A.R.S. §12-120.07 provides in pertinent part:

> "The opinions of a division or of a department of the Court of Appeals shall be in writing, the *grounds stated*, and shall be concurred in by a majority of a department if heard by department or of the division if heard by the division."

Thus, both the constitutional and statutory criteria for opinions of the appellate courts of this state are the same.

Black's Law Dictionary defines an "opinion" as:

> "The statement by a judge or court of the decision reached in regard to a cause tried or argued before them, *expounding the law as applied to the case, and detailing the reasons upon which the judgment is based.*" Black's Law Dictionary, Revised 4th Ed.

We of course recognize that the rules adopted by this Court provide for Memorandum Decisions, but we do not believe that the unpublished Memorandum Decision as it was characterized by the Court of Appeals meets either the statutory or constitutional requirements required of appellate courts in Arizona. The definition of an "opinion" contained in Black's Law Dictionary gives life to the long extant commonlaw definition of an "opinion" and breathes life into both the constitutional and statutory mandates that the opinions of the appellate courts of this state must be in writing and the reasons stated for the decision which the court reaches.

Additionally, any effective review of the decision of both the trial court and the Court of Appeals by this court is greatly diminished by virtue of the Court of Appeals having failed to discuss the issues in the appeal, the complete lack of authority cited for its conclusion and the complete lack of the reasons for the conclusion of the Court of Appeals.

As this court said in *Phelps Dodge Corporation v. Industrial Commission*, 90 Ariz. 379, 368 P.2d 450 (1962):

> "Essentially, petitioner's dissatisfaction is reflective of a problem not without some vexatious aspects. The constitution requires that the court's decision be in writing and the grounds stated. Article 6, Section 2. Certainly, parties to litigation are entitled to be advised of the reasons persuading the court to its conclusion."

This Court continued its discussion of the issue raised by *Phelps Dodge* and which is raised by Petitioner here in the following analysis:

> "Petitioner's assertion that the disposition 'was without fully considering the arguments advanced' gives us concern. If Petitioner means that the decision did not refute each argument advanced in Petitioner's brief, Petitioner is correct, it did not. Nor was it so intended. But if it is meant that the Court failed to negotiate with Petitioner the subtle course of its reasoning, then there is some justification in the request for reconsideration. We do not discourage applications for rehearing. It is the last opportunity to correct error. But here, it is plain that Petitioner was fully understood the first time around."

In the case at bench, it is impossible to determine whether the Petitioner's claims asserted in the Court of Appeals were fully understood or not. The cursory cavalier Memorandum Decision gives no hint as to what the issues even were let alone whether the Court fully understood them. There are no reasons stated other than that the Court of Appeals agrees with the trial court. There is no statement as to what the trial court held or why it did so. It merely says that a verdict was directed against the Plaintiff in favor of the Defendant and that decision is "affirmed". It certainly cannot be said that the Petitioner has been "advised of the reasons persuading the court to its conclusion.

It is respectfully submitted that at the very least before consideration of the issue presented under Point I, that the Court of Appeals should be required to write an opinion that this Court can effectively review.

Respectfully submitted this 25th day of June, 1985.

MARVIN JOHNSON, P.C.

By _____
John P. Otto
Attorneys for Appellant

COPY of the foregoing
mailed this 25th day of
June, 1985, to:

Jefferson L. Lankford, Esq.
JENNINGS, STROUSS & SALMON
111 West Monroe
Phoenix, Arizona 85003
Attorneys for Appellee

/s/ JOHN P. OTTO

APPENDIX "1"

IN THE COURT OF APPEALS
STATE OF ARIZONA
DIVISION ONE

HUGH KNOELL BUILDERS, INC., Plaintiff-Appellant, v. FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION, an Arizona corporation, Defendant-Appellee.	1 CA-CIV 7068 DEPARTMENT D MEMORANDUM DECISION (Not for Publication-Rule 28, Arizona Rules of Civil Appellate Procedure)

Appeal from the Superior Court of Maricopa County
Cause No. C-361349
The Honorable Joseph D. Howe, Judge
AFFIRMED

Marvin Johnson, P.C. by John P. Otto Attorneys for Plaintiff-Appellant	Phoenix
Jennings, Strouss & Salmon by Charles R. Hoover Michael A. Beale Jefferson L. Lankford Attorneys for Defendant-Appellee	Phoenix

This appeal has been considered by the Court, Presiding Judge Meyerson, and Judges Grant and Haire participating.

Appellant contends that the trial court erred in denying its motion for a new trial and entering judgment in favor of appellee upon a directed verdict. The basis of the trial court's ruling was that the appellant failed to establish any

damages resulting from appellee's alleged fraudulent conduct. We have carefully reviewed the offer of proof made by appellant at the conclusion of its case. We agree with the trial court that appellant failed to demonstrate any damages resulting from any action on the part of appellee.

Appellee may submit a claim for attorney's fees in accordance with Rule 21(c), Arizona Rules of Civil Appellate Procedure.

Affirmed.

APPENDIX "2"

BEST AVAILABLE COPY

APPENDIX "3"

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Plat No.	Description	Date Acquired	Type of Ownership	Book Value as of 12-31-78	Estimated Recovery as of 12-31-78	Net Book Value	Annual Lease or Rental	Assessed Value 1979 Projected Sales Price Basis	Remarks
92316 & 92317	Mitre Terms	10-31-75	Land	$ 584,883 1,511,520	$ 222,637	$ 1,511,520	$2,500 min	$1,222,500	Optimum Planting
92445	The Cutlass	9-25-75	Land Note	1,516,292	500,000	1,222,222	1,516,500	600,500	No sales activity reported
92483	Echo Canyon	8-9-76	Land	2,201,500	285,000	1,810,200	2,100,000	925,000	Sales planned 12-1-78 thru 3-31-82 $225,000 two $110,000 and one $0,200.
92477 thru 92480 & 92482	Shell Mill	5-20-75	Land	4,122,5332	640,000	3,482,200	1,100,000	0	No sales activity
92390 92398	Apache Primary Pipe	10-31-80	Land	1,120,302	-	1,120,302	1,819,500	210,000	Sales planned 12-1-78 thru 3-31-82 $22,000 two $60,000 and one $20,302.
92432	Sawyer Main Unit 3	10-2-74	Lease	930,000	-	930,000	937,000	200,000	No sales actually reported
92435	Terra Antlone	11-10-75	Lease	982,500	-	982,500	522,000	-0-	Not economic to market producing restrictions - Shipped with Plant/Wildlife
	Texas Pipeline	8-30-78	Land	1,022,552	200,000	142,432	1,012,000	-0-	
92332 thru 92333 and 92334	Texas Pipeline	8-30-78	Pipeline	1,012,200	20,202	1,011,200	1,200,250	210,000	Sales planned 12-1-78 thru 3-31-82 $20,000 two $20,000
92415 & 92416	The Arbors	1-23-78	Pipeline	822,920	-	822,920	22,000 to 31,500	265,000	All created
	Acoustic Glass	1-23-78	Pipeline Pipeline	196,422 722,022	- -	196,422 922,022	21,250 to 52,000	920,000	Two sale and creative. Sales planned 12-1-78 thru 3-31-82 $22,000 two $60,000 and one $0,000.
92402 92 92404 92 92406	Cactus Corners	8-4-76	Pipeline Pipeline	222,200 1,202,022	20,052	222,200 1,012,222	22,000 to 52,000	60,000	Two sale and creative. Sales planned 12-1-78 thru 3-31-82 $22,000 two $20,000 and one $0,000. Recovered Pipeline Corp.
92414 92 and 92416	Cantinas	1-23-75	Pipeline	492,222	22,200	220,222	22,500 to 52,000	1,000,000	Sales planned 12-1-78 thru 3-31-82 $22,000 two $20,000 and one $0,000.
	Apartment Complex	2-4-76	Pipeline	162,220	-	162,220	22,000 to 22,500	220,000	Sales planned 12-1-78 thru 3-31-82 $22,000 two $20,000 and one $1,000

APPENDIX "4"

TR of November 24, 1982, pgs. 3-5 and 15

(Pg. 3)

Q Is that what you mean?

A Yes, sir.

Q At all events, these were covered by either mortgages or deeds of trust which would have required foreclosure had the bank elected to proceed against you in the event of your not being able to pay, that's true, isn't it?

A Yes, sir.

Q Unless you were to have given a deed in lieu of foreclosure to just avoid all that procedure, short circuit the problems they'd have to go to and convey they, these particular pieces of land directly to the bank, that's true, isn't it?

A Yes, sir.

Q Whose idea was it, Mr. Knoell, whose idea was it for you to borrow the six hundred eighty-four thousand dollars?

A Well, it sure wasn't my idea.

Q Whose idea was it?

A The officers at First Federal.

Q Name them.

A Starting with Gene Rice, Earnie Modzewleski, Ron Sheridan, Greg Warthen —

Q W-a-r-t-h-e-n.

A After Wes left, the end of October, the next day we, meaning Joe and myself —

Q Pardon me, Joe, your son?

A My son. (Pg. 4)

Q Go ahead.

A Went into Bill Farrow's office and related that situation and then from there went immediately over to First Federal to tell them what happened and where

they were, we were. - think earlier Modzewleski knew pretty well where we were when we walked in, and even at that point, even though bankruptcy was the last thing in the world that I would want to do, during that month or couple weeks ahead of that we'd come to the decision there was probably no way out, and so we didn't — we walked into First Federal to say here's where we are and we don't see a way out. From that time on until the loan agreement was signed on December the 26th we went through a series of meetings, sometimes it's two meetings in one day, in Ron Sheridan's office, and constantly being warned that it was a bad idea to take bankruptcy, they would fix it up or see us through this in all different kinds of terms from the different people.

Q Let me interrupt you a moment. Did you discuss with them at any time before the Christmas loan was signed, did you discuss with them at any time how effective it would be to get the Christmas loan, whether that would in the end do you any good?

A I was just getting into that and in, well, the beginning (Pg. 5) of the loan agreement came out probably three or four weeks before we ever signed it and so it was discussed from time to time and we couldn't see our way out the other end of the tunnel. It would have done us no good just to prolong the bankruptcy for a few months, so it took a projection and the first talk of a five year projection, even though we had talked about in our office that it would take us five years to turn this around and attempt to pay the other fifty percent or the other quarter of a million dollars to the subs, the first talk of that was in Ron Sheridan's office, the meeting at which the loan went forward.

Q Who brought up the period five years?

A Ron Sheridan.

Q Tell the best —

A He said that they had projected that it would take five years to turn it around, that — and the only way that could be done was to finance future projects. We talked in that meeting of single family housing on the balance of the land that — at Quail Hill, or at least part of it. He talked about deeding the lots back to him, that they would carry Quail Hill at this point in time.

Q What does that mean?

A Well, be the land bank for the land at Quail Hill and we'd get it out on a release basis.

(Pg. 15)

A Well, our total overhead was in excess of a hundred thousand dollars.

Q A month?

A No, no — Oh, yes, a month.

Q And of that hundred thousand, or in excess of a hundred thousand, how much of that was going to pay interest?

A In the — Just over forty thousand, I looked it up.

Q To First Federal?

A Yes, sir.

Q Did you get rid of these subs, these claims?

A Well, we've settle with about half of them, on the fifty percent, we still owe some of it.

Q Well, I understand, but how did you get rid of the claims?

A Well, we got rid of the claims by me lending personal funds to Hugh Knoell Builders to pay them off.

Q How much of your personal funds by the way did you lend to Hugh Knoell Builders?

A It's in the area of sixty thousand dollars at this point.

Q But what I was getting at was this, of the money that you borrowed, the six hundred eighty-four thousand dollars, a quarter of a million dollars went toward getting rid of these subs, is that true.

A Yes, sir.

Q And then you executed three year notes to pay the other half.

APPENDIX "5"
TR of November 30, 1982, pgs. 41-44

(Pg. 41)

MR. OTTO: Well, in view of that testimony, Your Honor, we'll pass this witness and I'd like, if I may, call Mr. Knoell for just one question.

THE COURT: Would you have any questions of Mr. Rice at this time?

MR. HOOVER: I don't think we have any at this time, but if we reopen, we may later in the process.

THE COURT: You may step down, sir.

Which Mr. Knoell are you going to call?

MR. OTTO: Hugh.

THE COURT: Mr. Knoell, if you would retake the stand. I don't think I ever excused you, so you're still under oath.

MR. KNOELL: Yes.

THE COURT: As a party, we don't let you go.

MR. OTTO: You're the same Hugh Knoell who has testified before?

MR. KNOELL: Yes, Sir.

MR. OTTO: Mr. Knoell, on the Quail Hill property, why did you deed it by deed in lieu of foreclosure to First Federal?

MR. KNOELL: I addressed that, to some extent, when I was on the stand a few days ago, that the talk of the transactions and the transactions of deed in lieu and the sale of 77 were just prior to the granting of more money for general overhead expenses which was in the amount of $75,000. My recollection would be it was a deal that we couldn't afford to turn down. There's no place to go.

MR. OTTO: Are you saying you had no choice?

MR. KNOELL: Had no choice.

MR. OTTO: All right, sir. Can you tell us, please, at the time that First Federal took Quail Hill back, the value that they had loaned on the property of $3,329,635, how much

equity did you have in the property at that time over and above that First Federal credit number?

(Pg. 42)

MR. KNOELL: A dollar amount would be hard to put on it. This took place — the deed in lieu took place some five or six months, five months after the Christmas loan and even during that period, I think the land increased in value to a certain extent and kept on increasing.

MR. OTTO: What is your best judgment as to the dollar amount of your equity that First Federal got by forcing you to give them a deed in lieu of foreclosure?

MR. BEALE: Your Honor, I think it would be appropriate if we are seeing that. I do object on the basis of lack of foundation for him to give that opinion. He's already said he doesn't know.

MR. OTTO: Pardon me, Your Honor. He didn't say he didn't know. He just said that it's hard to do, is what he said.

THE COURT: Well, if you'll rephrase the question and show some foundation, I'll let you proceed along this line. The objection is sustained.

MR. OTTO: Well, you owned the land before giving the deed?

MR. KNOELL: Yes, sir.

MR. OTTO: And you're generally familiar with land values in Maricopa County during that time?

MR. KNOELL: Yes, sir.

MR. OTTO: All right, sir. Do you have an opinion as to what your equity in that land was worth when it was taken away from you by First Federal? The answer to that is either you do or you don't.

MR. KNOELL: Well, I do to the extent that there was an equity in there that Hugh Knoell Builders had. To relate it to the spring of '75, probably $300,000.

MR. OTTO: In equity?

MR. KNOELL: In equity.

MR. OTTO: All right sir, Thank you.

(Pg. 43)

That's all the questions we have.

THE COURT: Any questions of Mr. Knoell at this point?

MR. HOOVER: No, Your Honor.

THE COURT: You may step down, sir.

Anything further on the offer of proof?

MR. OTTO: No, Your Honor, that concludes our offer of proof.

THE COURT: Mr. Hoover?

MR. HOOVER: Well, Your Honor, I'd like to renew my motion. (Pg. 44) He made $543,000 on a $300,000 equity. He got more than he even thought it was worth and I don't think there is any evidence whatsoever to support any concept of any damage at all.

THE COURT: Mr. Otto?

MR. OTTO: I'm sorry, I didn't hear Mr. Hoover, Your Honor.

THE COURT: Well, I'm sorry I didn't realize that you were in conference. Would you say it again?

MR. HOOVER: I'll be happy to repeat what I said or try to. I can never say it verbatim.

Very simply, Mr. Knoell has not testified he has a $300,000 equity at the time that we gave him $543,000 for it. In terms of profit, we gave him $243,593 more than his equity. He couldn't possibly be injured. I renew my motion.

MR. OTTO: Your Honor, I think that is what they gave him, but the equity is on top of that.

THE COURT: Anything further?

Based on the evidence presented to the jury and the evidence in the offer of proof, I believe there is not evidence of damage and, therefore, I'll grant the motion.

Would you prepare a form?

I do not like to make such a ruling. I like parties to have their day to the jury, but I have listened attentively during all the damage testimony and I think Mr. Knoell's final testimony makes it clear that the plaintiff in this case, the corporation itself, did not suffer any damages.

APPENDIX "6"
TR, Vol. III, pgs. 169 & 182

(Pg. 169)

What did you mean?

A Well, the face of the financial statements showed improvement on the basis of profits reflected on the sale of this property, however, the profits on the sale of the property resulted from obligations against those properties being assumed or forgiven and those obligations were greater than the costs being carried on the books for those properties, and, as a result, since the company was relieved of liabilities in excess of the cost of the properties, that results in a profit, for accounting purposes.

Q You mean, for example, if Finley took it over, then in a sense, those — the debts that he owed on that property was also taken off his books?

A Well, yes, the debt was assumed by Finley Brothers, I believe was the name of the company.

Q Well, actually, you do know that Finley Brothers didn't, in fact, assume anything?

A I don't recall the details.

Q But what they did, they just took the deal relating to that property off of Knoell's books when they took the property away; is that what you are saying?

A Yes.

Q And you talk about a projection and counsel seemed to assume that we all know what that is and I'm not sure all of us do. What is a projection like you are talking

(Pg. 182)

Q Did you come to any conclusion as to what should be done about this?

A The conclusion was that we couldn't — the company could not make it and the only other alternative was bankruptcy.

Q You have heard Mr. Farrow say that was repugnant to you. Did you know of any other alternative to you to avoid that abhorrent situation?

A I did not.

Q Did you ever have any discussions, then, with Mr. Rice or anyone else at First Federal concerning this situation?

A Definitely.

Q Whom did you talk to?

A Different occasions I talked to most of the officers of First Federal including Mr. Rice, Mr. Modzelewski, Ron Sheridan, Greg Worthen. Jay Bernstein stopped me one time to tell me that: I know you're in trouble, we're going to help you out, but the most emphatic thing was in these various meetings that started in early November and went through to the Christmas loan. Innumerable occasions we were advised by one meeting, in particular, I remember, in Ron Sheridan's office.

Q We will come back to you.

If Your Honor please, I think it is a good time

APPENDIX "7"
TR, Vol. IV, pgs. 114-133 & 148-168

(Pg. 114)

Q And have you become pretty familiar with it?

A Yes, I have.

Q As a result of reading it and based upon what you know from your experience, your knowledge, do you have an opinion as to the condition of the institution, First Federal Savings and Loan, in '74, '75, and '76, the periods covered by Exhibit 1, as to its general condition as to what it was doing, how it was doing and —

A Yes, I have.

Q What is that opinion?

A The opinion is that the Association was in a fast growth period and that it was failing to meet certain net worth requirements and that it did make some very — it was heavily involved in speculative construction loans which were of great concern to the examiners and, generally speaking, their assets were considered to be substandard. Quite a bit of their assets were considered to be substandard.

Q Did you see any signs as to whether or not they were in so-called deep trouble?

A I would think that they were in deep trouble, yes.

Q And did you see any signs where they were (Pg. 115) attempting to give the bank examiners a so-called fast shuffle in some way?

A Well, I think that the manner in which they handled their loans and in which they handled the payment of interest on those loans keep them current could be viewed as giving somewhat of a fast shuffle.

Q Explain an example of what you mean by that, Mr. Quon.

A Well, when an association is heavily involved in construction lending as I've said before, the money is not disbursed all at one time and so the money is kept in a loans-in-process account and from there it is disbursed. Gen-

erally speaking, the money in the loans-in-process account will be sufficient to cover the costs to build the property, and, generally, will also include some of the interest that will be due to the association during the construction period. It will include supervision and overhead for the builder and it will include the building costs.

Now, it seems to me from what I've read in the reports, the real estate market in Phoenix was so bad that they used up the interest portion during the course of construction and still started debiting the loans-in-process, that is, taking loans — money from (Pg. 116) the loans-in-process account to keep the loans current even though the money originally earmarked for that had already been spent.

Q Let's take it another way. Bearing in mind that this is a kind of an unknown subject to most of us in this room and would you tell me that same thing, again, from another direction so it will be as plain as possible?

A Well, if you were to be building a house and if you had said that I am only going to allow you X number of dollars for lumber and that was the agreed on price and everybody agreed that that was enough to pay for the lumber and if along the way the builder comes along and says: I spent all of my other money and now I need some money that we have allocated for lumber to pay for plumbing and you say: but that won't leave me enough money to buy the lumber, that would be about the same analogy.

Q What was the effect of that?

A The effect is that you would end up short of money to build a house.

Q Well, is that anything sinister? So, you'll end up short. What's the big deal about this? What's wrong with that? Why do you remark about it?

A Generally speaking, the association (Pg. 117) wouldn't grant what we would call maximum loan to value in the first place. That is, they would be, if 80 percent of the value is all you could lend on the piece of property, generally, the sav-

ings and loan would give the builder an 80 percent loan. So, if he had a million dollar project, that meant that you could only lend $800,000 and, generally speaking, the loans would be about $800,000, which would mean that you were already lent up to the limit allowed by the regulation. If you did not have enough money left to complete the project, that means that you're going to have to lend more money. That means, now, that instead of having $800,000 loaned out, you may have $850,000 loaned out and the value would probably be the same. The value of the project would not have increased and so in those terms, you would have more outstanding in debt than you should have.

Q How do you avoid that?

A The only way to avoid that, I suppose, would be to reappraise the property and get it to be worth more money.

Q But if you had reappraised to show that it would be worth more money, isn't that just an exercise to make it look good since why would it (Pg. 118) necessarily go up in value from the time a loan was first granted?

A Well, in the construction of tract houses, large construction houses generally, an 18 month period would be what is normally thought of as a construction period. During the 18 month period, normally, especially if the houses were not completed, you would not expect to see the value go up and when an examiner looked at new appraisals and saw that the value had been increased, he would probably question that.

Q In other words, they were a subsequent appraisal, these new appraisals were rather artificial just to make it look good?

A That's what we would try to determine.

Q I see. Let me ask you this, sir. Does this happen where they would lend a builder money, where they knew before any money was loaned to him at all that before he'd sign the final instruments and take it out and all, did they do any

lending to builders of money where he knew he was not going to have enough money to finish the project?

A According to the examination report, yes.

Q What is the effect of that? What would be the effect of that if I need, say, $800,000 and (Pg. 119) I know it's going to take a million two to do this, yet they still lend me the $800,000. Why is that bad?

A Well, that's bad because we have already said — or I have already said that, hypothetically this property was only worth a million dollars. If you're going to need a million two to build it, it's going to cost you more to build than it's worth.

Q And that's bad from the standpoint of the examiner because of what?

A Well, that's bad not only from the standpoint of the examiner, the examiner would be commenting on the fact that it would be bad business practice for a savings and loan to do that.

Q Are you saying that they would be putting the savings and loan in a situation where they aren't treating their depositors' money carefully; is that what you're saying?

A Yes, sir.

Q Please tell whether you saw that the savings and loan, First Federal as shown in Exhibit 1, was quite preoccupied with the prospects or the possibility, rather, of a borrower's going into bankruptcy proceedings until such time as they got all the property in their own name? Did you see (Pg. 120) any signs of that in this report?

A Yes, there are a couple signs of that I can think of offhand.

Q Until, for example, with Mr. Knoell, did you observe anything like that?

A The examiner's report, I don't recall mentioning Mr. Knoell's properties in particular because the replies that

were given were replies to general questions about the Association's general attitude toward their speculative builders.

Q Tell this, please: When a builder had a lot of liens on the property, in your experience, what kind of a property was that? Why did that complicate things when a lot of people hadn't been paid money that they put in by way of labor and materials and liens were filed or recorded? Why did that concern the savings and loan company and/or the examiner?

A That was an indication, number one, to the examiners, that there may have been a laxness in the procedures in disbursing money, in disbursing the loan proceeds for construction. Number two, it would mean that money that had been allocated for a certain specific purpose may not have been used for that specific purpose.

(Pg. 121)

Q Well, why was it their business? Why, if they knew their builder couldn't, they say, well, we're going to give you 25 percent at this stage and so on? Why could they be preoccupied with how the disbursements were made or that the money was going into the right place?

A Well, they should be very preoccupied with that because it's very important what happens to that construction money once it leaves the association. If the builder does use it for the purpose it was intended and perhaps he might be using the money to pay other subcontractors, then that is what causes a lien to be filed because the subcontractor who didn't get the money, when he sees that he's not about to get the money, will file a lien on the property. A lien on the property is going to again increase the amount necessary to finish the project, get it free of liens so that you can sell the house is because you can't sell a house with a lien on it too well.

Q And so if they just told Knoell: we're going to lend you some money, why don't you pay half of the amount that you owe to these respective lien claimants and give them a note

for the other half, that had the effect of releasing the lien (Pg. 122) so that when they took over the property from Knoell it was free of those liens and no longer complicated their lives; is that the situation?

A It would be free of mechanics liens. It would just depend on the type of note that was signed to get the other 50 percent.

Q Let's say unsecured notes that were not on lien on that property at all.

A Then the liens would be off the property.

Q Then it's clear?

A Yes.

Q And then if they get hold of the property themselves, it was conveyed to them for any reason, then after that, after they get a hold of it, he can go out and do what he wants to and go broke if he want to and it doesn't bother them; is that generally true?

A That would appear to be true, yes.

Q Would you kindly give a comment as to what, if anything, you gathered from the report with regard to their taking this from one builder and giving it to another on a project at 77 East Missouri, where they took it from Knoell and gave it, with no liability, to another gentleman named Finley? Do (Pg. 123) you have any comment on that or an opinion on it?

A Well, according to the examination report, the property was securing a loan at First Federal and the property was owned by Knoell Builders. In the next examination report, the property had been taken over by Finley, but I have no way of knowing how the transfer of title took place.

Q What was the advantage, if anything, to the depositor of that savings and loan in getting it out of Knoell and over to Finley? Did it show a greater financial capacity or a greater skill on the part of Finley so far as you could tell?

A In fact, the examiner's comment in the 19—the late 1975 report, that Finley was just as bad as Knoell was, financially, and that there were other builders that were basically the same way, that is, they took over properties from previous builders who had loans at First Federal and the new builders were no better, in no better financial condition to carry out the debt repayment as the first builder.

Q I notice here on page 3 of Exhibit 1 it says: the management statements included in this report were presented to the examiners undated and unsigned, however, parts of all statements were (Pg. 124) presented to President Rice for his review and comment. No revisions or amendments were received from Mr. Rice and it was, therefore, assumed that he concurred with all statements.

Do you see that?

A Yes, sir.

Q Why do you — why was that put in there, if you know?

A Well, generally, when we — when the examiners speak to management, they ask for their replies in a written form and, in this case, evidently, the replies came from different management levels and they were unsigned and undated, so the examiner would have no way of presenting a written statement and attributing it to a specific person because it wasn't dated and it wasn't signed and so the examiner, in order to make sure that top management agreed with what was being said by other levels of management, showed them to the President and asked him to read them to make sure that he concurred with them. He's assuming that the concurrence was there because the President didn't contradict any of the statements.

Q I notice here that beginning on page 5 there are notes of the various — here's one builder (Pg. 125) that had $1,384,000 deficit in working capital; do you see that?

A Deficit of $262,000?

Q No, sir, the next one.

A Net worth total $192,000?

Q No, sir, the next one.

A $1,384,000 — oh, I see.

Q A deficit of working capital. In plain English, what does that mean, sir?

A That means that his bank accounts were overdrawn.

Q Say it again? I didn't hear.

A It means his bank accounts were overdrawn.

Q Just about a million three; right?

A Yes, sir.

Q I see. Regarding one company, there was no financial statement on file; do you see that on page 5, Germantown?

A Yes.

Q What's the significance of that?

A Well, what it says there — I'm paraphrasing. What it says is that there was a financial statement on file for the borrower's parent company, but there was no financial statement for (Pg. 126) the borrower itself, so that if he had Company A which owned Company B and Company B was your borrower, if you had no financial statement for Company B, there was some doubt as to whether or not you could go after Company A if Company B defaulted, so you should know the financial statement of Company B as well as perhaps Company A, depending on how much Company B depended on its parent for working capital.

Q Would you be kind enough to come down to the board and draw that picture of what you just said, Mr. Quon?

A I'll try.

Q Would you mind doing that?

A I'll try.

Q Pull that around to where it's convenient for you and where everyone can see it, please. You can bring it out here,

Mr. Quon, if you'd like to. I think it would be easier to see. Thank you. Let's let the Judge see it, too.

THE COURT: If it's put up here, sometimes that works. That takes a little wheeling and dealing, I guess, to get it up here.

THE WITNESS: Company A owns Company B among other companies, we'll say —

(Pg. 127)

Q BY MR. JOHNSON: You say owns or loans?

A Owns.

And if Company B goes to the lender and borrows money from the lender, the lender should have a financial statement for Company B because that is their primary lender, I mean borrower. If Company B defaults on the loan, Company B may be the only company that has the right to go after — for the money, but in this case, they didn't have a financial statement for Company B, but they did have one for Company A. Company A, being the parent, properly is in a much better financial condition than Company B. Company B is sometimes referred to as a shell corporation which is set up for a specific project and so when that project or if that project should not sell, go down the tubes, this company really doesn't lose out anything because there is only a shell. There's nothing there other than that property that was being developed.

Q Are you saying, therefore, that sometimes it's pretty complicated, legally, to make another company pay the first company's debt in case the first company went under?

A Yes, sir.

Q Kind of like making one man pay another (Pg. 128) man's notes, so to speak?

A So to speak.

Q Okay. I notice here on page 6 it says that there were seven loans granted totaling, in round figures, $16,400,000 during the review period where it did not require sufficient

borrower's equity. What does borrower's equity mean and what do they mean by that comment, please?

A A borrower's equity is what the borrower has of his own money into a project.

Q Let me put it this way and see if I can get agreement from you.

I have a house worth $50,000 and I owe $40,000 on it and I have $10,000 in borrower's equity.

A That's right. If you were to buy that house for $50,000 and you put $10,000 down and borrowed $40,000, then the $10,000 would be your equity, the borrower's equity and here when it says that the granted seven loans totaling 16 million dollars, the significance of that, I suppose, is that, number one, there are large loans because seven loans for 16 million dollars is an excessive average of two million dollars apiece, and they did not require sufficient borrower's equity means that the borrower (Pg. 129) did not have much cash equity into the project.

Q What's to prevent their lending whomever they want whatever amount they want?

A Well, again, there are specific regulations determining the amount to loan of value of the property, so in the same $50,000 house that we were talking about, if I wanted to buy it for $50,000 and I had a $10,000 cash down payment and borrowed $40,000, I would be perfectly okay as far as regulations was concerned because that's an 80 percent of value. 80 times $50,000, but if you were to have less equity than that from the regulatory standpoint, that would not be enough. That means that you had to borrow the money somewhere else to make up the equity.

Q When they have done things like that, are they — like the examiner barking, what can they — I think you've told us all they can do. Are things like this kind of a "boys will be boys" situation, or are these extraordinary situations?

A These are extraordinary situations. They would certainly not, in the examiner's eye, be "boys will be boys" situation.

Q This is just not done by legitimate companies on a systematic basis; is that what you're saying?

A I'm saying that the examiners would be (Pg. 130) of the opinion that they should not be done and they would not be done if the savings and loan were following good business practices.

Q I notice here on page 9, the dramatic consequences of Watergate. Do you know of any reason Watergate did anything to the First Federal Savings and Loan Company when they themselves reported back: no one seemed to have a better exception of a dramatic consequences of Watergate; what does that mean?

A What you're referring to is a letter from one of the management people and the report does not identify who made this statement, but it was a written reply by one of the management people as to why the Association did not require greater equity investment by the borrowers and in the reply, the management person wrote that: no one seemed to have a good perception of the dramatic consequences of Watergate, the reaction of inflation and the coming credit crunch. All I can imagine is that the writer wanted to say that there was no one that could foresee all of the things happening.

Q Look at page 72 where the President — Chairman of the Board at that time, Mr. George Leonard, Sr., said also: I disagree with the statement that the primary objective was to salvage the builders (Pg. 131) rather than to salvage specific assets.

To you, does that mean that the object was to help themselves and not help the builders, that's what Mr. Leonard was saying?

A I really don't know what Mr. Leonard was saying. Although I think that what Mr. Leonard wanted to say is that

he did not agree with the examiner's statement that the Association was primarily out to help the builders rather than the projects.

Q Look at page 59. It says, among other things, that the net worth to total assets is well below the ratio of other associations in its asset class.

Please tell — do you see that?

A Yes.

Q Please tell what that means: in its asset class. Who's in its asset class in this area?

A In this area?

Q Yes, sir.

A Today?

Q Yes, sir — no, well, no. In 1974, '75, '76.

A Well, even in those days, I suppose in the Phoenix area, I think First Federal was about (Pg. 132) a billion dollars or so and I think that the only ones that would have been in their asset class here in Phoenix would have been Western Savings.

Q On page 61 it says: the Association exhibits only a casual compliance with the federal and insurance regulations. Evidence of this is found in the number of regulatory violations noted by the examiners and the response of management when informed of these violations.

Is that consistent with what your opinion is from examining that report which is Exhibit 1, Mr. Quon?

A Yes, sir.

Q I notice on page 53 and 52 where the examiner said that Finley Construction in this transfer of assets from Knoell doesn't itself — and I'm paraphrasing — show the financial capacity to service these obligations and must depend solely on sales to repay or reduce his outstanding debt.

Do you see that, sir?

A Yes, sir, I do.

Q That being the assertion, tell whether it would be better assuming that they had similar building capabilities and skills for the operating contractor to actually have a stake in liability (Pg. 133) in getting the thing done rather than to have no stake or liability in getting the thing done. Do you understand what I'm saying and, if so, lead me out of the wilderness.

A I think that what the examiner is saying is that they were definitely in no better position by having Finley, by having Finley finance loans that were originally to Hugh Knoell Builders because Finley was in no better position to pay back the debt and I don't know what other inferences you could draw from that except that Mr. Finley probably had to have more money and I think that that is one of the things that they pointed out that they did lend Mr. Finley some more money again to help him bail out of the project.

Q Pardon me, Mr. Quon, a moment.

Your honor, may we come to the bench for just a moment?

THE COURT: Yes.

(Whereupon there was a brief off-the-record discussion.)

THE COURT: Ladies and gentlemen, I'm going to ask you to excuse us. Consider this your mid-afternoon recess. We have a meeting to take care of.

(Whereupon the jury left the courtroom.)

(Pg. 148) of jury and counsel and the parties.

Ladies and gentlemen, Mr. Johnson was feeling ill and so he asked to be relieved of responsibility for the rest of the afternoon. So, he's gone home and Mr. Otto will proceed and Mr. Johnson wants me to assure you that it wasn't that he was feeling unkindly toward anyone. His health was feeling unkindly toward him.

Mr. Otto, you may proceed.

Mr. Quon is on the witness stand.

MR. OTTO: Thank you, Your Honor.

CONTINUED DIRECT EXAMINATION
(Of Mr. Henry Quon)

BY MR. OTTO:

Q Mr. Quon, to go back just a little bit, are you able to tell from reviewing the record, for example, if First Federal knew that an examination was coming shortly after the first of the year in 1975, and you indicated that they would have known that in late '74 and '75 that they had prior notice of the coming examination. Assuming that they knew that, can you tell us whether it would have been or was to First Federal's advantage to loan to Hugh Knoell Builders more money in December prior to the (Pg. 149) examination if that loan resulted in getting the liens off the Quail Hill property and -- well, first of all, was it to their advantage to get the liens off the property?

A It would have been to First Federal's advantage to get the liens off the property, yes.

Q Would it have been to First Federal's advantage to pay itself the interest that was due on the loans to Hugh Knoell Builders?

A Yes, it would have been to its advantage.

Q Let's talk about that for just a moment, if we may. When an examiner comes in to look at a federally insured savings and loan association, is it true that one of the hallmarks that they look for as far as classifying loans is concerned and criticizing those loans to the association management, is whether or not the loans are up to date and the interest has been paid on them?

A Certainly.

Q If they come in and they see a loan that the interest hasn't been paid on, is that a red flag to the examiner?

A Well, it means that the loan is delinquent and all delinquent loans would probably deserve some scrutiny of some kind.

(Pg. 150)

Q Would it be fair to say that the probability would be that if a loan that interest had not been paid up to date and there was not sufficient — there were not sufficient funds to keep the project going, that a loan like that would be classified by the examiners —

A If a loan was delinquent, it would be what is known as a scheduled item and if a loan is not delinquent, then if an examiner, through his examination and judgment, feels that it's substandard, then it would be classified as substandard, but that has a different meaning than a scheduled item.

Q It would be immediately a scheduled item if the loan interest were not up to date; would that be true?

A It would depend on how delinquent. Usually, a loan would have to be 60 days delinquent or more for it to be a scheduled item, generally speaking.

Q But as soon as they saw that the interest was not paid, that loan would be sought out for specific scrutiny; would that be correct?

A Yes, especially if it was a large loan.

Q All right, sir.

Now, so it would be clearly to First Federal's (Pg. 151) advantage to do that with reference to Hugh Knoell Builders; true?

A To keep the interest current?

Q Yes, sir.

A Yes, it would be to their advantage.

Q Particularly when they knew that an examination was coming; would that be correct?

A That might be one of the reasons to keep it current.

Q Sure. All right, sir.

You've told us about, I believe, and let me go back and just recap because, unfortunately, I wasn't listening as closely as I should to all of Mr. Johnson's questions. If I'm

repeating what he asked, please forgive me. I'll try not to do that.

First Federal had a policy of what the examiners described as journaling interest out of loans; is that true?

A Yes, there is quite a bit of comment about journaling interest from loans-in-process, yes.

Q First of all, tell us, if you would, please, what does that mean in words that I can understand and not banker's jargon?

A What it means is that when you make a construction loan, as I said, you don't need all of (Pg. 152) the money at one time, so you put the money in an account called loans-in-process and there you disburse the money as the builder needs it and in that loans-in-process account would be money for construction purposes, money for overhead and supervision and money, generally, to pay interest on the loan during the course of construction. That was the normal practice. So, what you do when interest came due, you would take the money out of loans-in-process and apply it to a loan and bring it current. Now, that was fine so long as you didn't go beyond the 18 month period or you didn't deplete the amount allowed for interest.

Q Did First Federal do those things, though?

A It seems from the examiner report that the examiner's comment was that it was taking more out of loans-in-process for interest than had been allowed for interest.

Q Is this a fair characterization, Mr. Quon, what First Federal was doing in order to try to keep the examiners happy and make the loans look as though they were okay, at least on paper, was that they were taking the money out of one pocket and saying: here, Mr. Knoell, I'm going to lend you seven dollars to pay the interest on your loan, but (Pg. 153) you don't get it. I'm going to put it over here in this pocket and then I can consider that as earned income; is that what they were doing?

A That would be a characterization of what they were doing, yes. The thing is that they had already lent him the money and they were taking it out of one pocket and putting it into the other to pay themselves for interest.

Q And they held onto all that money. For all the time that Hugh Knoell is supposed to have that money, First Federal really had it in their pocket; didn't they?

A That would be the way it would be done, yes.

Q And the way that makes it look is for the bank examiners come in — is that a method of covering up what the true posture or the true position of that loan really is?

A Well, from the examiner's standpoint, there would be no objection to it if that money was being taken out of loans-in-process during the course of construction and if it was set aside for that purpose. The examiners would comment on it and take exception to that practice if they were taking more out of the loans-in-process account than had been (Pg. 154) allocated for interest and therefore keep the loan current.

Q And it's true that this report soundly, roundly, and continuously criticized First Federal for taking more money out of loans-in-process to pay its interest than had been earmarked for interest; isn't that right, sir?

A That's true.

Q All right, sir. Would it have been — please, sir, tell me, to the advantage of First Federal Savings to pay the interest long enough so that, hopefully, the loan would not be criticized by the examiners and they gave Mr. Knoell just enough money in order to complete the Quail Hill project, for example? Would it have been to their advantage to complete the Quail Hill project considering that it was in some stage of construction other than finished?

MR. HOOVER: Let me object to the question as being leading. I think the witness has already testified and that's a leading question.

THE COURT: You know this is the one that isn't really all that leading. I'm going to overrule you on this, but —

MR. HOOVER: I waited one too long. I would (Pg. 155) request that counsel —

MR. OTTO: I'll avoid leading. I'll try not to do that.

Q BY MR. OTTO: Can you answer my last question? Would it be to their advantage to keep Hugh Knoell in business long enough to complete the Quail Hill project?

A Yes.

Q Why?

A Well, a savings and loan really doesn't want to acquire property that's not finished. They certainly wouldn't want to acquire property that wasn't finished and there wasn't enough money in the loans-in-process to complete it, but in terms of taking interest out of the loans-in-process, I think that not only do you keep the loan current, but you also generate income for yourself.

Q So, you do a two-fold thing, then, by loaning them extra money; is that what you're telling me?

A Yes, sir.

Q All right, sir. Would it be to First Federal's advantage to be able to acquire the Quail Hill property and the 77 East Missouri property, for that matter, without any lease on it? Was (Pg. 156) that to their advantage?

A Yes, it's always more advantageous to acquire property lien free.

Q Was it the position of the management of First Federal that they would do whatever they could to keep these builders who had half completed projects out of bankruptcy?

A Yes, the report indicates that.

Q Did the examiners criticize First Federal for doing that?

A Yes, they did.

Q Did the management take, in response to the criticism of the Federal Home Loan Bank Board as contained in the report, did First Federal's management defend their position and say: yes, we wanted to do that?

A Yes, I think they did. In one of the letters that they wrote to the examiner, they specified that it was their — it had been their policy to make loans which were 100 percent of the builders' costs and that it would be to their advantage to keep the builder, to keep the builder up to date rather than allowing their creditors. So, yes, I would have to say that that was one of their stated policies.

Q And that, again, was all to First Federal's advantage; is that true?

A Yes.

Q Even though the Board took the position that that was an unsound business practice and might even violate the regulations?

A The Bank Board examiners would take the position that is not good business practice to lend 100 percent of what a builder needs because the builder has lost or has no equity and, really, has lost his incentive to stay with the project.

Q Let me go back to something that Mr. Johnson touched on very briefly with you, Mr. Quon, and that is the Finley Construction Company taking over the 77 East Missouri property.

Can you tell from examining the report, would it have been to First Federal's advantage to make it appear as though Finley Construction had taken over 77 East Missouri as opposed to First Federal helping Hugh Knoell Builders to finish that project? Was there any advantage in what it would look like to the examiners or what they hoped it would look like to the examiners in rolling 77 East Missouri over into Finley Construction as opposed to letting Mr. Knoell finish it?

A Well, I suppose from the examiner's (Pg. 158) standpoint, it may look as though the Association is trying to work its way out of the troubles and had gotten rid of a borrower who was not performing. So, from that standpoint, the examiner probably would have looked at that and said: oh, good, they got rid of that bad guy, now they have got another guy in.

Q But they got caught at it; didn't they?

A The examiner looked at the new borrower who came on board and he said that he was not financially able to carry the debt either.

Q So, what they're saying is that Finley had no more ability than Hugh Knoell Builders to finish 77 East Missouri; would that be correct?

A That would appear to be what they're saying, yes.

Q Can you tell us if this had been successful on paper? It looked like they had a new borrower, Finley Construction Company, whose interest was paid up to date; would that be true or false?

A If the examiner did not have any reason to delve into it, he probably would have looked at it — at the new borrower and said: fine.

Q That's okay?

A Right.

(Pg. 159)

Q But the examiner looked more into depth into that loan situation and why Finley took over; is that true?

A He looked at that transaction quite in depth and commented on it in the November, '75 examination report.

Q All right, sir. Is this a fair statement: when the examiners went in there with reference to Hugh Knoell Builders and they found out that First Federal had been journaling interest and they shouldn't have, they found out that they had taken a project away from Hugh Knoell Builders and

given it to Finley Construction in an attempt to make that loan look like it was okay on the books; is that a fair statement?

A Well, that's what they would have found, yes.

Q And they caught them at it, too; didn't they?

A They certainly found out that Finley got the same project that Hugh Knoell Builders had.

Q And they found out they were paying themselves interest out of money they loaned to Hugh Knoell which wasn't supposed to be interest didn't they?

(Pg. 160)

A Yes.

Q All right, sir. They also found out that First Federal had loaned the money to Knoell to pay, in cash, 50 percent of the materialmen and that they had also gotten Hugh Knoell to get the liens off the property by giving a note of Hugh Knoell Builders, Inc., to the materialmen for the other 50 percent of their liens.

A That was covered on page 18.

Q All right, sir. Can you tell us, Mr. Quon, based upon your training and experience, sir, with the federal examination report such as contained in Exhibit 1, and, particularly, the report which started with — well, first let me ask you this: I think the date of the first report in there is it February 4th of 1975?

A February 3rd of 1975.

Q Third, sorry.

That report, that date means the date the examination started; right?

A Yes.

Q But the examination goes backward in time and covers what they have been doing up until February 4th of 1975; isn't that right?

A Yes, they would have covered a period (Pg. 161) from their last examination to the February date and if while they were there, if anything of significance happened, they would cover that, also.

Q They would also cover that while they were there doing the examination which, how long would you say an examination of this nature would take, sir?

A Well, an examination of an association of a billion dollars or greater with the problems that First Federal had, it would have taken months. I would say it would take a minimum of six months or more.

Q Long time?

A Yes.

Q And the examiners would be there all the time during that period, I take it?

A Yes.

Q All right, sir.

MR. OTTO: If I might have just a moment, Your Honor?

THE COURT: Certainly.

Q BY MR. OTTO: Let me ask you perhaps one final question, Mr. Quon.

If First Federal knew what it knew in February of 1975, and it knew what it knew based upon your (Pg. 162) examination of the examination report in December of 1974, if it knew that the loans were in the situation as they are reflected in this report, and First Federal also knew that they were about to be examined shortly after the first of the year, can you tell me why they would do the things that they did do: journaling interest, paying themselves interest, things like getting the liens off, changing from one builder to another to make it look like it was a new builder, and a new loan and an up-to-date loan? What impact, if the truth became known to the examiners, would those kinds of things had upon First Federal from the examiners' point of view?

MR. HOOVER: Now, I would like to object. That one is compound.

THE COURT: That is sustained.

Q BY MR. OTTO: All right, sir. From what you have seen in this report and assuming that First Federal knew all the things that this report reflects they do and did, can you tell us, sir, what impact that would have if the examiners found those things out?

MR. HOOVER: Same objection, Your Honor. It also is without foundation.

THE COURT: That's sustained.

(Pg. 163)

Q BY MR. OTTO: How does management react to criticism by the examiners?

MR. HOOVER: Let me object to the form of the question. It's ambiguous, doesn't identify management.

THE COURT: Sustained.

Q BY MR. OTTO: Generally speaking, you're familiar with how the President, the Chairman of the Board, and executive officer and Senior Vice President as to what impact criticism in this examination has on them? Are you generally familiar with that?

A Yes.

Q Are you generally familiar with the impact that severe criticism in an examination report has on the institution itself, that is, the savings and loan?

A Yes.

Q Please tell what impact criticism of management has on that management.

A Well, if you have a report that contains a lot of criticism, what it does, I think, is that for one thing, it really ties up management in terms of trying to explain things to the examiner and then it ties up the management in terms of having to explain their problems to the supervisory agent

and, (Pg. 164) as I said before, the examiner probably has very little power to exercise any supervision, however, the management people would wait and see what supervisory agents from San Francisco had to say. That's the kind of impact that an examination report has.

Q If you get a bad examination report, what happens when the supervisory people in San Francisco and Washington see that report? What do they do about it?

A Well, they get a little upset and they get a little nervous and they write letters and they want to know what the Board of Directors is doing to take care of the problems that are pointed out by the examiner.

Q Based upon your examination of the report, was First Federal in a position as a result of the examination which began on February 3 of 1975, were they in a position where they either did lose or were in jeopardy of losing their power to make certain kinds of loans?

A Oh, yes.

Q Please tell me about that.

A Well, I mentioned before that there is a difference between substandard assets and scheduled (Pg. 165) items. There is no concrete definition of a substandard asset in the regulations, but there is a specific definition of scheduled items in the regulations and when the savings and loans scheduled items reach a certain ratio of their assets, they are estopped from certain powers. For instance, they're estopped from selling loans, participation loans to other lenders. They are probably stopped from doing other — having other investments and so the lower you keep the scheduled item ratio the better and if the examiner feels that you are doing certain things in order to circumvent the scheduled item regulation, they may call those substandard assets and comment on them in the fashion that they were, here, just to point out to supervision that if they were allowed to call these substandard assets, scheduled items, you'd have a situ-

ation where you would be over the ratio limit and, as I remember, the ratio was about two and a half percent.

Q So, can you tell us, then, if based upon the report you have an opinion as to whether or not First Federal had a compelling interest to keep the scheduled items down as low as possible in the February 3, 1975 examinations?

A Yes, I would think so because of their (Pg. 166) scheduled item figures that the report shows and the substandard assets that the report shows.

Q All right, sir. Can you comment on — or would you please comment on the effect of an association advertising heavily in getting in a lot of depositors' money when at the same time that association may be prevented from making certain kind of investments and may be prevented from making certain kinds of loans?

A Well, my comment would be that the examiner, on page 2, says that the Association was practicing certain things that caused it to offer higher than average rate on savings accounts and, I think, that what the examiner was saying is that the Association was attracting what is known in the industry as jumbo C.D.s because that's the only type of savings where the associations in that time were not regulated as to the rate that they could pay and in attracting the high cost money you had to be able to lend it out.

Q So if you couldn't lend that money out, you're in big trouble with paying them interest you promised to pay the depositors?

A And you had to lend it out at a higher rate than agreed to pay otherwise you'd be in a losing (Pg. 167) proposition.

Q Yes, sir.

Would you give us your opinion, sir, based upon your examination of these examination reports, how would you describe the position and the condition of First Federal insofar as the examiners were concerned in late '74 or early '75?

A The examiners were obviously very concerned about their lending, about the manner in which they were soliciting savings. They were very concerned about the controls over such things as disbursements and appraisals and they were very concerned about the Association's ability to make a profit, to make their reserve transfers and whether or not the Association was going to meet its net worth requirements.

Q And that's obvious to you from the examination report?

A Yes, it is.

Q Would it have been obvious to First Federal's management, as well, sir?

A Yes, sir.

Q All right. Let me ask you, in closing, please, Mr. Quon, if you would look on page 48 of the report, please. Look under item 2B, if you would, sir, where it says: regulatory violations are so (Pg. 168) widespread that it indicates that management had lost control of its operating expertise.

A Yes, I see that.

Q Is that — what did that mean in words I can understand, not being a banker?

A Well, it means that the examiner felt that there were so many violations of the regulations that it seemed that management had just lost any control over whether or not it could continue to meet the regulations or even worried about them.

MR. OTTO: Take the witness.

THE COURT: Before we start cross examination, could I see counsel, briefly?

(Whereupon there was a brief off-the-record discussion.)

THE COURT: Cross examine?

CROSS EXAMINATION

BY MR. HOOVER:

Q Mr. Quon, if I understand correctly, you're here in the private capacity and you're not a representative of the Federal Home Loan Bank Board; is that correct?

A That's correct.

Q And you're being compensated for being here?

APPENDIX "8"

TR, Vol. V, pgs. 21-24, 47-48 & 90-91

(Pg. 21)

THE COURT: Court is in session. The record may show the presence of jury, counsel, and parties.

Ms. Baker, I excused you yesterday. I am going to ask that you be re-sworn.

BARBARA BAKER,

being first duly sworn, was examined and testified as follows:

THE COURT: Please take the witness stand. Go ahead.

DIRECT EXAMINATION

BY MR. JOHNSON:

Q Ms. Baker, yesterday I neglected to ask you the final important question: Have you calculated the amount of interest that was paid by Hugh Knoell Builders to First Federal with reference to the $684,000 so-called Christmas loan, that was made in December of 1974?

A Yes, I have.

Q Would you please tell the jury how much money Hugh Knoell Builders paid to First Federal on the December 26th, 1974 loan?

A The amount is $48,724.

Q I'm sorry?

A $48,724.

(Pg. 22)

Q Over what period of time did they pay that money?

A December 26th, '74, through September 11th, 1975.

Q All right. And do you know why that period of time was involved?

A The security on the loan had been some parcels at Quail Hill and they had been taken back by First Federal at that time.

Q First Federal took them back and took them over; is that true?

A That is correct.

Q And those units he finished when they took them over?

A No, these were raw land.

Q Raw land is which nothing had been built?

A Correct.

Q They made them pay interest on that land until First Federal took back all the rest of Quail Hill; is that true?

Q Yes.

MR. JOHNSON: Thank you, ma'am, no further questions.

THE COURT: Cross-examine?

MR. BEALE: No, Your Honor.

THE COURT: May the witness be excused?

MR. JOHNSON: I hope she may.

THE COURT: You are excused again. Thank you very much.

MR. JOHNSON: Your Honor, we rest.

(Pg. 23)

THE COURT: There are matters that need to be taken up at this time?

MR. BEALE: Yes, Your Honor.

THE COURT: Ladies and gentlemen, I am going to excuse you. We have certain matters of law. You are getting a lot of exercise this morning. We appreciate your patience.

(Whereupon, the jury left the courtroom.)

THE COURT: The jury is out.

Before we begin on the defense motion, let me advise you that the juror, Skinner, just talked with me and said she was worried that she might have a problem. She heard the name Mike Johnson and, apparently, she served on the jury in a trial recently which was not completed because it was set-

tled. There was the son of a prominent lawyer, his son's name was Mike Johnson. He was one of two or three defendants.

MR. JOHNSON: That's Art Johnson's, certainly no relation at all.

THE COURT: Well, she was concerned and she said it would not influence her in any way in this case, but she wanted to avoid a mistrial, so I told her I would mention it to counsel and I did not think that there was a relationship.

MR. JOHNSON: He finished medical education and then decided to be a lawyer, young Mike Johnson.

MR. BEALE: It's vice versa, Marvin. He was a lawyer, (Pg. 24) first, then he decided to be a doctor at the University of Guadalajara.

THE COURT: Well, I will reassure her that there is no connection. She just wanted to make sure there would not be a mistrial.

Okay. Mr. Hoover?

MR. HOOVER: Your Honor, the defense would like to make a motion for Directed Verdict. Very basically, let me explain to you our grounds.

This lawsuit started out with what appeared to be three separate counts, three separate claims. One of them seemed to sound in contract, one of them seemed to sound in fraud, and the third one usury.

The usury count was, quite clearly, abandoned by the plaintiffs on the first morning set for trial, the 15th of this month. That is no longer in the case.

When you read the pretrial statement, it's pretty clear that we're not dealing with a contract action, either. All the things that they contend that they are going to deal with prove and, looking forward to the fraud issues, there are obviously reasons why they, in effect, abandoned that one, also. The integrated contract rule would obviously prohibit them from claiming a contract of some sort before December 27,

1974, dealing with some sort of assistance to be done over some period of time. The testimony is even vague on what that is, (Pg. 47) real estate owned projects and First Federal said: Wouldn't you like to buy this from us for so much money that you can't make any money on it, but: No, we don't want to do the project that we discussed doing when we were promising to work you out of this, when we were in the lulling situation, when we were trying to get even with the Feds, when we were trying to save our own skin and survive and try to make the kind of loans we had to because First Federal, in its corporate wisdom, had gotten in so much money in these jumbo CDs that they didn't have any place to invest it that would pay the kind of interest they had to pay.

THE COURT: Okay. Now, we will recess for about ten minutes.

(Whereupon, a brief recess was taken.)

THE COURT: Back on the record. The record should show the presence of counsel and the parties. The jury is absent.

Let me tell you, John, number one, the representations conceded for the argument, number two, evidence of falsity, you've argued that, number three, materiality. There is an argument about the fact that it doesn't appear and Exhibit 12 indicates it wasn't material. Four and five and six and seven are all conceded, so then you get to the right to rely (Pg. 48) with advice of lawyers and accountants; how could a reasonable person rely? My disposition on that is that is probably a jury question, so you need not hit that very heavily. The point I want you to hit with some emphasis would be number nine, damages.

MR. OTTO: Let me go directly to that, if I may.

MR. HOOVER: Your Honor, I think element number four, you stated that we conceded in the course of the argument.

THE COURT: I am sorry, the speaker's knowledge of the falsity. I was wrong on that, but I think that that is covered by the argument on number two.

MR. OTTO: Yes, I think that I've spoken to that.

We believe that there clearly is sufficient inferences to be drawn and create a judicible jury issue. If I may, Your Honor, let me pass to the issue of damages.

Now, what the evidence demonstrates, I think, is clearly this: In December of 1974, Knoell was in a position that his lawyers and accountants advised him there is no way that this company can make it. The company should either be folded or it should take bankruptcy. At that point, First Federal appears upon the scene and says: Oh, no, for God's sake, don't do that. You stick with us, we'll stick with you, we'll see you through this and we'll even —

THE COURT: Yeah, I understand all that. What I want to know is how was the plaintiff corporation damaged?

MR. OTTO: It took on, Your Honor, two things that (Pg. 90) values in Maricopa County during that time?

MR. KNOELL: Yes, sir.

MR. OTTO: All right, sir. Do you have an opinion as to what your equity in that land was worth when it was taken away from you by First Federal? The answer to that is either you do or you don't.

MR. KNOELL: Well, I do to the extent that there was an equity in there that Hugh Knoell Builders had. To relate it to the spring of '75, probably 300,000.

MR. OTTO: In equity?

MR. KNOELL: In equity.

MR. OTTO: All right, sir. Thank you.

That's all the questions we have.

THE COURT: Any questions of Mr. Knoell at this point?

MR. HOOVER: No, Your Honor.

THE COURT: You may step down, sir.

Anything further on the offer of proof?

MR. OTTO: No, Your Honor, that concludes our offer of proof.

THE COURT: Mr. Hoover?

MR. HOOVER: Well, Your Honor, I'd like to renew my motion. He made $543,000 on a $300,000 equity. He got more than he even thought it was worth and I don't think there is any evidence whatsoever to support any concept of (Pg. 91) any damage at all.

THE COURT: Mr. Otto?

MR. OTTO: I'm sorry, I didn't hear Mr. Hoover, Your Honor.

THE COURT: Well, I'm sorry I didn't realize that you were in conference. Would you say it again?

MR. HOOVER: I'll be happy to repeat what I said or try to. I can never say it verbatim.

Very simply, Mr. Knoell has not testified he has a $300,000 equity at the time that we gave him $543,000 for it. In terms of profit, we gave him $243,593 more than his equity. He couldn't possibly be injured. I renew my motion.

MR. OTTO: Your Honor, I think that is what they gave him, but the equity is on top of that.

THE COURT: Anything further?

Based on the evidence presented to the jury and the evidence in the offer of proof, I believe there is not evidence of damage and, therefore, I'll grant the motion.

Would you prepare a form?

I do not like to make such a ruling. I like parties to have their day to the jury, but I have listened attentively during all the damage testimony and I think Mr. Knoell's final testimony makes it clear that the plaintiff in this case, the corporation itself, did not suffer any damages.

We are adjourned, thank you.

APPENDIX "9"

APPENDIX "9"

"In May, 1975, the company conveyed the undeveloped land and lots it owned at its Quail Hill project to the mortgagee, First Federal Savings and Loan Association, in exchange for the complete release of all indebtedness on the land and lots. The cost of the land and the lots was $2,786,042 and the liabilities released totaled $3,329,635."